

**AGENDA — July 25, 2000 Business Taxes Committee Meeting**  
***Warranty Deductibles and Lemon Law Returns (Regulation 1655, Returns, Defects and Replacements)***

<b>Action 1 — Consent Item</b>  Adoption of proposed amendments to Regulation 1655 to incorporate provisions about vehicle returns under the California Lemon Law and about deductibles paid on mandatory and optional warranty contracts 1. Lemon Law returns – 1655(b)(2) 2. Deductibles paid on warranty contracts – 1655(c)(4)	Adopt proposed amendment(s) to Regulation 1655 as agreed upon by industry and staff.
<b>Action 2 — Authorization to Publish</b>	Direct the publication of the proposed amendments to Regulation 1655, Returns, Defects and Replacements as adopted in the above action.  Operative Dates: None Implementation: Upon OAL approval

**AGENDA — July 25, 2000 Business Taxes Committee Meeting**  
**Warranty Deductibles and Lemon Law Returns (Regulation 1655, Returns, Defects and Replacements)**

Action Item	Staff and Industry's Proposed Regulatory Language
<p><b>Action 1 — Consent Item(s)</b></p> <p>Adoption of proposed amendments to Regulation 1655 to incorporate provisions about vehicle returns under the California Lemon Law and about deductibles paid on mandatory and optional warranty contracts</p> <p>1. Lemon Law returns – 1655(b)(2) Exhibit 3, pages 1 and 2</p>	<p>Regulation 1655, Returns, Defects and Replacements</p> <p>(b) Defective Merchandise</p> <p><u>(2) Restitution or Replacement Under California Lemon Law.</u></p> <p><u>(A) General. Under subdivision (d) of Civil Code section 1793.2, if a manufacturer is unable to service or repair a “new motor vehicle,” as that term is defined in subdivision (e)(2) of Civil Code section 1793.22, to conform to the applicable express warranties after a reasonable number of attempts, the manufacturer must either replace the motor vehicle or provide the buyer restitution of the purchase price, less specified amounts, at the buyer’s election.</u></p> <p><u>(B) Restitution. A manufacturer who pays a buyer restitution pursuant to, and in complete compliance with, subdivision (d)(2) of Civil Code section 1793.2 is entitled to a refund of the amount of sales tax or sales tax reimbursement included in the restitution paid by the manufacturer to the buyer. The manufacturer may file a claim for refund of that amount with the board. The claim must include a statement that the claim is submitted in accordance with the provisions of section 1793.25 of the Civil Code. The manufacturer must submit with the claim documents evidencing that restitution was made pursuant to, and in complete compliance with, subdivision (d)(2) of Civil Code section 1793.2 including: a copy of the original sales agreement between the buyer and the dealer of the non-conforming motor vehicle; copies of documents showing all deductions made in calculating the amount of restitution paid to the buyer along with full explanations for those deductions, including settlement documents and odometer statements; a copy of the title branded “Lemon Law Buyback” for the non-conforming motor vehicle returned by the buyer; and proof that the decal the manufacturer is required to affix to that motor vehicle has been so affixed in accordance with section 11713.12 of the Vehicle Code. The manufacturer must also submit with the claim the seller’s permit number of the dealer who made the retail sale of the non-conforming motor vehicle to the buyer, and evidence that the dealer had reported and paid sales tax</u></p>

**AGENDA — July 25, 2000 Business Taxes Committee Meeting**  
**Warranty Deductibles and Lemon Law Returns (Regulation 1655, Returns, Defects and Replacements)**

Action Item	Staff and Industry's Proposed Regulatory Language
<p>2. Deductibles paid on warranty contracts – 1655(c)(4) Exhibit 3, page 3</p>	<p><u>on the gross receipts from that sale. For purposes of this regulation, the number of attempts made to repair the non-conforming motor vehicle, if any, prior to providing the customer restitution is not relevant for purposes of determining whether restitution has been made pursuant to subdivision (d)(2) of Civil Code section 1793.2.</u></p> <p><u>(C) Replacement. For purposes of this regulation, a manufacturer who, pursuant to subdivision (d)(2) of Civil Code section 1793.2, replaces a non-conforming motor vehicle with a new motor vehicle substantially identical to the motor vehicle replaced is replacing the motor vehicle under the terms of the mandatory warranty. No additional tax is due unless the buyer is required to pay an additional amount to receive the replacement motor vehicle, in which case tax is due measured by the amount of that payment. If an amount is refunded to the customer as part of the exchange of the non-conforming motor vehicle for the replacement motor vehicle, then that amount is regarded as restitution for purposes of this regulation if it satisfies the requirements of subdivision (d)(2) of Civil Code section 1793.2. The manufacturer may file a claim for refund under subdivision (b)(2)(B) of this regulation for the amount of sales tax or sales tax reimbursement that is included in the amount of that restitution paid by the manufacturer to the buyer. For purposes of this regulation, the number of attempts made to repair the non-conforming motor vehicle, if any, prior to providing the customer a replacement is not relevant for purposes of determining whether the replacement has been made pursuant to subdivision (d)(2) of Civil Code section 1793.2.</u></p> <p>(c) Replacement Parts - Warranties</p> <p><u>(4) Deductibles. A deductible paid by a customer under the terms of a mandatory or optional warranty contract is subject to tax measured by the amount of the deductible allocable to the sale of tangible personal property to the customer. For example, if the itemized sales price of tangible personal property (or the fair retail value if not separately itemized) provided pursuant to a warranty is 50 percent of the total fair retail value of the repairs and the deductible is \$100, 50 percent of that deductible, \$50, would be allocable to the sale of tangible personal property and would be subject to tax, whether the warranty were optional or mandatory. Unless otherwise stated in the warranty contract, when either an optional or a mandatory warranty provides that the customer will pay a deductible towards repairs and services provided under the warranty, the person providing the warranty contract is liable for any tax or tax reimbursement otherwise payable by the customer with respect to that deductible.</u></p>

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- ☐ Board Meeting
- ☒ Business Taxes Committee
- ☐ Customer Services and Administrative Efficiency Committee
- ☐ Legislative Committee
- ☐ Property Tax Committee
- ☐ Other

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## **Regulation 1655, *Returns, Defects and Replacements*: Lemon Law Returns and Deductibles Paid Under Warranty Contracts**

### **I. Issue**

Should Regulation 1655, *Returns, Defects and Replacements*, be amended to include language concerning: 1) the application of tax to deductibles paid by customers on warranty contracts, and 2) the refund of sales tax on restitution for motor vehicles coming within the Lemon Law provisions of the Civil Code?

### **II. Staff Recommendation**

Staff recommends that Regulation 1655 be amended as proposed: 1) add subdivision (c)(4) to the regulation, which provides that a warrantor is liable for any tax or tax reimbursement that would otherwise be payable by the customer as the result of a deductible payment unless the warranty contract specifically states that the customer is liable for the tax or tax reimbursement. Staff recommends no operative date since the recommended change is a regulatory interpretation of the Sales and Use Tax Law as it applies to existing industry practices; and 2) add subdivision (b)(2), which provides dealers and manufacturers with regulatory guidelines for reporting Lemon Law transactions. Subdivision (b)(2) has no operative date. It is based on Civil Code section 1793.25, which allowed to the Board to refund sales tax to manufacturers on Lemon Law returns. This provision became operative on January 1, 1988, which predates any relevant statute of limitation. Consequently, an operative date is not required in the regulation.

### **III. Other Alternative(s) Considered**

Make no changes to Regulation 1655.

**FORMAL ISSUE PAPER**Issue Paper Number 00 - 024**IV. Background**

The proposed amendments to Regulation 1655 are staff-initiated and are designed to provide regulatory authority for guidelines on:

- The application of tax to customer-paid deductibles on optional and mandatory warranty contracts.
- The refund of sales tax when a vehicle is found to be defective under the Lemon Law provisions of the Civil Code.

For several years, staff has dealt with these issues using administrative guidelines. The proposed amendments incorporate these guidelines into the regulation.

Interested parties have indicated no disagreement with the proposed amendments.

Discussion of Warranty Contracts

The proposed amendment to Regulation 1655 concerning warranty contracts explains the application of tax to deductible payments made in connection with warranty repairs. Repairs for which a customer pays a deductible are only partially covered by the warranty contract. The current regulation explains the application of tax when parts are furnished under the warranty contract when no deductible is paid. It does not explain the application of tax to deductible charges paid by the customer.

Under the current regulation, the application of tax when a part is furnished under a warranty contract depends on whether the contract is mandatory or optional. When a seller provides a mandatory warranty contract, the charge for the contract is subject to tax along with the item sold. Parts furnished under a mandatory contract are considered as included in the original sales price of the item for which the warranty is provided. Consequently, the warrantor, under a mandatory contract, may purchase the parts for resale and no tax is due when the parts are furnished. In contrast, the selling price of an optional warranty is not subject to tax, and the warrantor is the consumer of any parts it furnishes to fulfill its obligations under that optional warranty contract. Tax applies either to the sale of the parts to the warrantor or, if the warrantor purchases the parts without tax, to the warrantor's cost of the parts.

Although Regulation 1655 does not currently address the application of tax to deductible payments, these payments may have a tax consequence. The Sales and Use Tax Law generally imposes tax on a transfer of tangible personal property for consideration. When a customer pays a warranty deductible, a portion of which covers the cost of a repair part, there is a transfer of the part to the customer for consideration and the amount paid by the customer for the part is subject to tax.

The staff provided guidelines on the application of tax to deductible payments in the June 1994 and June 1996 *Tax Information Bulletin*. The June 1994 article, *Application of Tax to Deductibles on Automobile Warranty Contracts*, provided an overview of the application of tax to parts used on warranty contracts. The article also discussed the proper method for reporting tax when a customer pays a deductible on a mandatory warranty. The June 1996 article, *Correction: Application of Tax to Deductibles on Optional Automobile Warranty Contracts*, provided the same overview. In addition, the article discussed the proper method for reporting tax when a customer pays a deductible on an optional warranty contract. Although both articles were written in response to the practices of automobile manufacturers, the

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guidelines apply to any mandatory or optional warranties, whether provided by the manufacturer, retailer, or separate warranty company.

Following is an example of how tax applies to deductibles paid in connection with warranty repairs:

An appliance manufacturer provides a warranty with the sale of a stove, the customer brings the stove in for a warranty repair, and the repair is made by a third-party repairer. The repairer bills the manufacturer for the repairs, which includes charges for both parts and labor. If the warranty is mandatory, the repairer's sale of the parts to the manufacturer is a sale for resale because the cost of warranty parts is included in the sales price of the stove. If the warranty is optional, the repairer's sale of the parts to the manufacturer is subject to tax because the manufacturer is the consumer of the parts. Similarly, if the manufacturer itself performed the repairs, it would purchase the parts furnished under a mandatory warranty for resale, while tax would apply to its cost of parts furnished under an optional warranty.

In contrast, when the warranty requires the customer to pay a deductible, the portion of the deductible amount which covers the customer's cost of a part is subject to tax whether the contract is mandatory or optional. In the example above, if the customer was required to pay a deductible on the warranty service for the stove, the repairer would be making a retail sale of a portion of the parts to the customer. The other portion is being sold to the warrantor.

The June 1994 article provided guidelines for determining the measure of tax for deductibles paid on mandatory warranty contracts. It noted that there is no tax consequence when the repairs are entirely labor, since the deductible is paying only for labor. On the other hand, if the entire charge for the repair is for parts, then the entire deductible is also for parts and the entire deductible would be subject to tax. However, the article noted that the most common situation is where the repairs include both parts and labor. In such cases, the deductible pays a prorated portion of the parts and labor. Accordingly, a portion of the deductible is for the purchase of parts, and tax applies to that amount of the deductible.

For example, a customer is required to pay a \$50 deductible for a repair under a mandatory warranty. The total charge for the repair work is \$200: \$75 for parts and \$125 for labor. The measure of tax on the deductible is computed as follows:  $\$75 \div \$200 = 37.5\%$ . The deductible is multiplied by 37.5% to determine the taxable portion of the deductible (\$18.75). The remaining charge for the parts, \$56.25, is not taxable because the repairer sold it to the warrantor for resale as discussed above. Whether tax reimbursement is paid to the repairer by the customer or by the manufacturer depends on the terms of the warranty contract.

The June 1996 article covers the same points as the June 1994 article. In addition, it provides guidelines for applying deductibles to optional warranty contracts. As noted above, the sale of a part to a warrantor under an optional warranty is generally subject to tax. If the warranty contract provides that the warrantor will pay all tax reimbursement due, then the repairer would bill the warrantor for tax reimbursement due on the charge to the warrantor as well as on the deductible charge to the customer, meaning that the repairer would not need to prorate the deductible between a charge for parts and a charge for labor. However, unless the warrantor agrees to pay the amount of tax reimbursement due in connection with the deductible portion of the repairs, a repairer providing parts and labor must prorate the deductible to determine the proper amount of tax reimbursement to collect from the warrantor and from the customer. Using the example in the preceding paragraph, \$75 (37.5%) of the total charge of \$200 is subject to tax. If the warrantor agreed to pay all tax reimbursement, the repairer would bill the warrantor \$150 (\$200 less

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the \$50 deductible) plus tax reimbursement on \$75, collecting the remaining \$50 from the customer as the deductible. Otherwise, the repairer would collect \$150 from the warrantor plus tax reimbursement on the \$56.25 worth of parts attributable to the charge to the warrantor, and would collect \$50 from the customer plus tax reimbursement on the \$18.75 worth of parts attributable to the deductible.

The proposed amendment places the general administrative guidelines in Regulation 1655 as subdivision 1655(c)(4), (Exhibit 3). A comparison of the current and proposed language for Regulation 1655 is shown in Exhibit 2. The proposed subdivision explains the application of tax to deductible payments and provides an example of how to prorate such payments in order to report the correct amount of tax. It also clarifies the information provided in the *Tax Information Bulletin* articles on one significant point. Namely, the proposed subdivision specifically provides that the person providing the warranty contract is liable for any tax or tax reimbursement that would otherwise be payable by the customer as the result of a deductible payment unless the warranty contract specifically states that the customer is liable for the tax or tax reimbursement. In effect, this would be a regulatory finding that, unless the parties specifically state to the contrary in the warranty contract, they intend that customers pay only the actual amount of the deductible specified in the warranty contract, with the warrantor picking up all other amounts due, including any applicable tax reimbursement. In contrast, the *Tax Information Bulletin* articles assumed that the customer was liable for the tax reimbursement unless the warranty contract stated that the warrantor agreed to pay the tax.

Discussion of Lemon Law Provisions

The California Lemon Law was enacted by sections of the California Civil Code. As provided in these sections, a vehicle manufacturer must either provide a replacement vehicle or restitution to the buyer of a defective new motor vehicle, as defined. These provisions apply if a defect that substantially impairs the use, value, or safety of the vehicle cannot be serviced or repaired to conform to the applicable express warranty. It is the buyer's choice as to whether to take a replacement or restitution.

When the buyer elects restitution, Civil Code section 1793.25 (operative January 1988) allows the manufacturer to file a claim for refund with the Board for the sales tax or sales tax reimbursement included in the restitution made by the manufacturer to the buyer. Prior to the adoption of this provision, a refund of sales tax could not be granted to the manufacturer since the manufacturer was not the person making the retail sale of the vehicle and reporting sales tax to the Board. To ensure that refunds are properly made to manufacturers, the staff has developed administrative guidelines that explain when and how a manufacturer may claim a refund of tax under a restitution agreement. These guidelines are provided in Operations Memo (OM) 907, *Reimbursement of Sales Tax Refunded Under the "Lemon Law."* Manufacturers can also obtain a refund of sales tax or sales tax reimbursement included as part of restitution made to a buyer when the buyer elects replacement with a vehicle of lesser value than the nonconforming vehicle.

To ensure that manufacturers and dealers understand how to report Lemon Law transactions correctly, the proposed amendment incorporates both OM 907 guidelines into Regulation 1655. The following discussion details the Civil Code provisions that make up the Lemon Law and guidelines from OM 907.

The pertinent provisions of the California Lemon Law are contained in sections 1793.2, 1793.22, 1793.23, 1793.24, and 1793.25 of the California Civil Code. Subdivision (d)(2) of Civil Code section 1793.2 applies specifically to new motor vehicles. It provides that if a manufacturer is unable to repair

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the vehicle to conform to the applicable express warranties after a reasonable number of attempts, the manufacturer must replace the vehicle or provide the buyer restitution, at the buyer's option. In the case of a replacement, the manufacturer must provide a substantially identical new vehicle, provide the standard warranties, and pay any sales or use tax, license, registration or other fees, plus incidental damages. In the case of restitution, the manufacturer must pay an amount equal to the price paid, including charges for transportation, manufacturer options, and collateral charges such as sales tax, license, registration or other fees, plus incidental damages. In both cases, the manufacturer may reduce the value of the restitution or replacement by an amount attributable to the use made by the buyer prior to the time the buyer first delivered the vehicle to the repair facility for correction of the problem giving rise to the nonconformity. This amount is calculated as: miles traveled prior to service ÷ 120,000 miles x the price of the vehicle.

Section 1793.22 is the Tanner Consumer Protection Act. It provides guidelines for designating a vehicle as a "lemon." The section establishes the presumption that a reasonable number of attempts have been made to bring the new motor vehicle into conformity with the applicable express warranties if, within 18 months from delivery to the buyer or 18,000 miles, whichever comes first, four or more repair attempts have been made to repair the same nonconformity, or the vehicle has been out of service for a cumulative total of more than 30 calendar days by reason of repairs of the nonconformity since delivery to the buyer. The section also requires the buyer to participate in any available qualified third-party dispute resolution process, as defined, prior to asserting the presumption discussed above. Section 1793.23 requires that the manufacturer give notice that a vehicle returned under the Lemon Law is or has been defective. The vehicle must be retitled in the name of the manufacturer and the ownership certificate inscribed with the notation "Lemon Law Buyback" and a decal affixed to the vehicle with the same notation. In addition, any person who acquires the vehicle for resale must notify potential buyers that the vehicle was a Lemon Law buyback.

Section 1793.24 specifies the information that must be in the notice required by section 1793.23 and the format of the notice.

Section 1793.25 authorizes the Board to make refunds of sales tax to a manufacturer in connection with Lemon Law restitution and replacements. The manufacturer must file a claim for refund as specified in the Sales and Use Tax Law (see RTC § 6901, et seq.). As part of that claim, it must provide proof that the dealer who sold the vehicle reported sales tax to the Board. The manufacturer must also provide satisfactory proof that it branded the title "Lemon Law Buyback" and attached the decal required by Vehicle Code section 11713.12, as required by Civil Code section 1793.23 and satisfied the other requirements of the Lemon Law.

Staff established guidelines for Lemon Law transactions in Operations Memo (OM) 907, *Reimbursement of Sales Tax Refunded Under the "Lemon Law."* OM 907 requires any vehicle for which a manufacturer claims a refund because of a restitution agreement be properly treated as a defective vehicle under the above Civil Code provisions. In addition, OM 907 requires specific documentation on any vehicle replacement for which a manufacturer claims a refund or net liability.

The criteria for claiming a tax refund for restitution are detailed in OM 907, section V, Claims for Refund. Manufacturers who file a claim for "reimbursement" with the Board must state that the refund of tax was made to the buyer in accordance with Civil Code Section 1793.2. The manufacturer must also explain how the refund was calculated using odometer readings and settlement agreements, and include proof that



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the tax was paid by the dealer who sold the vehicle. A statement from the dealer that sales tax was paid is adequate proof. Finally, the manufacturer must provide sufficient documentation to prove that the restitution was made under the provisions of the Lemon Law. This documentation must include:

- A copy of the original sales agreement,
- A copy of the replacement vehicle sales agreement (if applicable),
- Documentation supporting that a reasonable number of attempts have been made to repair the vehicle,
- A statement from the buyer verifying they were given the choice of restitution versus vehicle replacement (if applicable),
- Copy of documents to support the amount refunded to the buyer and/or any financing entity holding title (e.g. check(s) issued),
- The sales tax permit number of the original retailer,
- Copies of arbitration documents (if applicable),
- A copy of the branded title of the reacquired vehicle,
- Copies of refund computation worksheets, and
- A copy of the repair history to support mileage amount when the vehicle was first reported for the nonconformity.

Normally, a refund of sales tax can be claimed only by the retailer who legitimately reported tax on the original sale, and a manufacturer of a new motor vehicle who did not make the taxable retail sale is allowed to file a claim only if it complies with the specific criteria provided in the Civil Code.

Accordingly, a manufacturer's claim must be denied if the manufacturer fails to document that it provided restitution as a result of the Lemon Law, in strict compliance with the Civil Code provisions. For example, a manufacturer may not file a claim if it reduces the reimbursement to the buyer by an amount in excess of the formula provided in section 1793.2 of the Civil Code.

The tax consequences of replacing a vehicle vary depending on the selling price of the replacement. When the replacement vehicle's selling price is the same as the amount to be returned for the defective vehicle, there are no tax consequences. A replacement vehicle that has a selling price that is greater than the amount to be returned on the defective vehicle will result in a tax liability for the dealer. A Lemon Law replacement vehicle that has a selling price that is less than the amount otherwise required to be returned to the buyer for the defective vehicle will result in a refund of the difference as restitution to the buyer, along with the sales tax or sales tax reimbursement paid on that amount by the buyer. When the manufacturer complies with the requirements of the Lemon Law in making this restitution with sales tax or sales tax reimbursement, it may file a claim for refund for the actual amount of tax refunded to the buyer.

To provide dealers and manufacturers with regulatory guidelines for reporting Lemon Law transactions, a new subdivision, 1655(b)(2), is proposed for Regulation 1655 (Exhibit 3). A comparison of the current and proposed language for Regulation 1655 is shown in Exhibit 2. The current paragraph under subdivision (b) will be renumbered as subdivision (b)(1). The new subdivision substantially incorporates

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the documentation guidelines in OM 907. It requires a manufacturer who claims a refund for a defective vehicle to provide the following documentation to support that restitution or replacement was made under the provisions of the Lemon Law:

- A copy of the original sales agreement between the buyer and dealer for the nonconforming vehicle.
- Copies of documents showing all deductions made in calculating the amount of restitution paid to the buyer, along with full explanations for those deductions. These documents must include the settlement documents and odometer readings.
- A copy of the branded title for the nonconforming vehicle and proof that the manufacturer affixed the requisite decal to the vehicle.
- The seller's permit number for the dealer who sold the nonconforming vehicle to the buyer and evidence that the dealer reported and paid sales tax on the gross receipts from that sale.

The proposed amendment does not require the manufacturer to document the number of attempts made to repair the vehicle. The reason for this is that the reference in the law to repair attempts is not a *minimum* number of repair attempts required under the Lemon Law, but rather a *maximum* number that triggers the presumption that a reasonable number of attempts to repair the vehicle have been made. Thus, the number of repair attempts, if any, is not relevant to determining whether the replacement or restitution complies with the Lemon Law as long as all the criteria under the Lemon Law are satisfied. These criteria are:

- The vehicle must have been brought in for repair of a defect within 18 months of the purchase date.
- The reduction in the value of restitution or of the replacement vehicle must have been calculated only on the use that occurred prior to the first time the vehicle was brought in for repair of the nonconforming defect.
- The manufacturer must have branded title, placed a Lemon Law decal on the vehicle, and properly informed subsequent buyers that the vehicle was returned under the provisions of the Lemon Law.

## **V. Staff Recommendation**

### **A. Description of the Staff Recommendation**

Staff recommends that Regulation 1655 be amended as proposed: 1) add subdivision (c)(4) to the regulation, which provides that a warrantor is liable for any tax or tax reimbursement that would otherwise be payable by the customer as the result of a deductible payment unless the warranty contract specifically states that the customer is liable for the tax or tax reimbursement. Staff recommends no operative date since the recommended change is a regulatory interpretation of the Sales and Use Tax Law as it applies to existing industry practices; and 2) add subdivision (b)(2), which provides dealers and manufacturers with regulatory guidelines for reporting Lemon Law transactions. Subdivision (b)(2) has no operative date. It is based on Civil Code section 1793.25, which allowed to the Board to refund sales tax to manufacturers on Lemon Law returns. This provision became operative on January 1, 1988, which predates any relevant statute of limitation. Consequently, an operative date is not required in the regulation.

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**B. Pros of the Staff Recommendation**

- Clarifies application of tax to Lemon Law transactions and warranty deductibles.
- Incorporates into the regulation administrative guidelines already in effect.

**C. Cons of the Staff Recommendation**

None

**D. Statutory or Regulatory Change**

No statutory change required, however, recommendation does require an amendment to Regulation 1655.

**E. Administrative Impact**

None. Policies are already in effect.

**F. Fiscal Impact**

**1. Cost Impact**

Costs related to the amendment are absorbable.

**2. Revenue Impact**

None. See Exhibit 1, *Revenue Estimate*.

**G. Taxpayer/Customer Impact**

Policies already exist and have been publicized. Incorporating the amendments into the regulation will make reporting guidelines more accessible to taxpayers.

**H. Critical Time Frames**

Subdivision (c)(4) has no operative date. It is a regulatory interpretation of existing law as it applies to industry practices. Subdivision (b)(2) has no operative date. As stated in the section Staff Recommendation, it is a regulatory interpretation of Civil Code section 1793.25

**VI. Alternative 1**

**A. Description of the Alternative**

Make no changes to Regulation 1655.

**B. Pros of the Alternative**

None.

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**C. Cons of the Alternative**

Regulation 1655 would not reflect current industry practices and Board administrative policies.

**D. Statutory or Regulatory Change**

None.

**E. Administrative Impact**

None.

**F. Fiscal Impact**

**1. Cost Impact**

None.

**2. Revenue Impact**

None. See Exhibit 1, *Revenue Estimate*.

**G. Taxpayer/Customer Impact**

Information on proper reporting would be less accessible.

**H. Critical Time Frames**

None.

Prepared by: Program Planning Division, Sales and Use Tax Department

Current as of: July 11, 2000



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## REGULATION 1655, *RETURNS, DEFECTS AND REPLACEMENTS*: LEMON LAW RETURNS AND DEDUCTIBLES PAID UNDER WARRANTY CONTRACTS

### Staff Recommendation

Staff recommends that Regulation 1655 be amended as proposed: 1) add subdivision (c)(4) to the regulation, which provides that a warrantor is liable for any tax or tax reimbursement that would otherwise be payable by the customer as the result of a deductible payment unless the warranty contract specifically states that the customer is liable for the tax or tax reimbursement. Staff recommends no operative date since the recommended change is a regulatory interpretation of the Sales and Use Tax Law as it applies to existing industry practices; and 2) add subdivision (b)(2), which provides dealers and manufacturers with regulatory guidelines for reporting Lemon Law transactions. Subdivision (b)(2) has no operative date. It is based on Civil Code section 1793.25, which allowed to the Board to refund sales tax to manufacturers on Lemon Law returns. This provision became operative on January 1, 1988, which predates any relevant statute of limitation. Consequently, an operative date is not required in the regulation.

### Background, Methodology, and Assumptions

There is nothing in the proposed revisions to Regulation 1655 that would impact revenues.

### Revenue Summary

The staff recommendation has no revenue effect.

### Preparation

This revenue estimate was prepared by David E. Hayes, Statistics Section, Agency Planning and Research Division. This revenue estimate was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division and Ms. Charlotte Paliani, Program Planning Manager, Sales and Use Tax Department. For additional information, please contact Mr. Hayes at (916) 445-0840.

Current as of July 10, 2000

**Regulation 1655, Returns, Defects and Replacements: Lemon Laws Returns and  
Deductibles Paid Under Warranty Contracts  
Comparison of Current and Proposed Language**

Current as of June 26, 2000

Action Item	Current Regulatory Language	Regulatory Language Proposed by Staff	Summary Comments
<b>Action 1 — Consent.</b>	<p><b>(a) RETURNED MERCHANDISE.</b> The amount upon which tax is computed does not include the amount charged for merchandise returned by customers if, (1) the full sale price, including that portion designated as "sales tax", is refunded either in cash or credit and (2) the customer, in order to obtain the refund or credit, is not required to purchase other property at a price greater than the amount charged for the property that is returned. Refund or credit of the entire amount is deemed to be given when the purchase price, less rehandling and restocking costs, is refunded or credited to the customer. The amount withheld for rehandling and restocking may not exceed the actual cost of rehandling and restocking the returned merchandise. However, in lieu of using the actual cost for each transaction, the amount withheld for rehandling and restocking may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle (generally one year). If the seller elects to withhold rehandling and restocking amounts based on a percentage of sales price, the seller is bound by that election for the entire accounting cycle for which the election is made and must apply that percentage in lieu of actual cost during that period on all returned merchandise transactions for which rehandling and restocking costs are withheld. The amount withheld as rehandling and restocking costs may not include compensation for increased overhead costs because of the return, for refinishing or restoring the property to salable condition where the necessity therefor is occasioned by customer usage, or for any expense prior to the "sale" (i.e., transfer</p>	<p><b>(a) RETURNED MERCHANDISE.</b> The amount upon which tax is computed does not include the amount charged for merchandise returned by customers if, (1) the full sale price, including that portion designated as "sales tax", is refunded either in cash or credit and (2) the customer, in order to obtain the refund or credit, is not required to purchase other property at a price greater than the amount charged for the property that is returned. Refund or credit of the entire amount is deemed to be given when the purchase price, less rehandling and restocking costs, is refunded or credited to the customer. The amount withheld for rehandling and restocking may not exceed the actual cost of rehandling and restocking the returned merchandise. However, in lieu of using the actual cost for each transaction, the amount withheld for rehandling and restocking may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle (generally one year). If the seller elects to withhold rehandling and restocking amounts based on a percentage of sales price, the seller is bound by that election for the entire accounting cycle for which the election is made and must apply that percentage in lieu of actual cost during that period on all returned merchandise transactions for which rehandling and restocking costs are withheld. The amount withheld as rehandling and restocking costs may not include compensation for increased overhead costs because of the return, for refinishing or restoring the property to salable condition where the necessity therefor is occasioned by customer usage, or for any expense prior to the "sale" (i.e., transfer</p>	

**Regulation 1655, Returns, Defects and Replacements: Lemon Laws Returns and Deductibles** Paid Under Warranty Contract  
**Comparison of Current and Proposed Language**  
 Current as of June 26, 2000

Action Item	Current Regulatory Language	Regulatory Language Proposed by Staff	Summary Comments
	<p>of title, lease, or possession under a conditional sale contract).</p> <p>Sellers must maintain adequate records which may be verified by audit, documenting the percentage used.</p> <p><b>(b) DEFECTIVE MERCHANDISE.</b></p> <p>Amounts credited or refunded by sellers to consumers on account of defects in merchandise sold may be excluded from the amount on which tax is computed. If, however, defective merchandise is accepted as part payment for other merchandise and an additional allowance or credit is given on account of its defective condition, only the amount allowed or credited on account of defects may be excluded from taxable gross receipts. The amount allowed as the "trade-in" value must be included in the measure of tax.</p>	<p>of title, lease, or possession under a conditional sale contract).</p> <p>Sellers must maintain adequate records which may be verified by audit, documenting the percentage used.</p> <p><b>(b) DEFECTIVE MERCHANDISE.</b></p> <p><u>(1) IN GENERAL.</u> Amounts credited or refunded by sellers to consumers on account of defects in merchandise sold may be excluded from the amount on which tax is computed. If, however, defective merchandise is accepted as part payment for other merchandise and an additional allowance or credit is given on account of its defective condition, only the amount allowed or credited on account of defects may be excluded from taxable gross receipts. The amount allowed as the "trade-in" value must be included in the measure of tax.</p> <p><u>(2) RESTITUTION OR REPLACEMENT UNDER CALIFORNIA LEMON LAW.</u></p> <p><u>(A) General.</u> Under subdivision (d) of Civil Code section 1793.2, if a manufacturer is unable to service or repair a "new motor vehicle," as that term is defined in subdivision (e)(2) of Civil Code section 1793.22, to conform to the applicable express warranties after a reasonable number of attempts, the manufacturer must either replace the motor vehicle or provide the buyer restitution of the purchase price, less specified amounts, at the buyer's election.</p> <p><u>(B) Restitution.</u> A manufacturer who pays a buyer restitution pursuant to, and in complete compliance with, subdivision (d)(2) of Civil Code section 1793.2 is entitled to a refund of the amount of sales tax or sales tax reimbursement included in the restitution paid by the manufacturer to the</p>	

**Regulation 1655, Returns, Defects and Replacements: Lemon Laws Returns and Deductibles** Paid Under Warranty Contract  
**Comparison of Current and Proposed Language**  
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		<p><u>buyer. The manufacturer may file a claim for refund of that amount with the board. The claim must include a statement that the claim is submitted in accordance with the provisions of section 1793.25 of the Civil Code. The manufacturer must submit with the claim documents evidencing that restitution was made pursuant to, and in complete compliance with, subdivision (d)(2) of Civil Code section 1793.2 including: a copy of the original sales agreement between the buyer and the dealer of the non-conforming motor vehicle; copies of documents showing all deductions made in calculating the amount of restitution paid to the buyer along with full explanations for those deductions, including settlement documents and odometer statements; a copy of the title branded "Lemon Law Buyback" for the non-conforming motor vehicle returned by the buyer; and proof that the decal the manufacturer is required to affix to that motor vehicle has been so affixed in accordance with section 11713.12 of the Vehicle Code. The manufacturer must also submit with the claim the seller's permit number of the dealer who made the retail sale of the non-conforming motor vehicle to the buyer, and evidence that the dealer had reported and paid sales tax on the gross receipts from that sale. For purposes of this regulation, the number of attempts made to repair the non-conforming motor vehicle, if any, prior to providing the customer restitution is not relevant for purposes of determining whether restitution has been made pursuant to subdivision (d)(2) of Civil Code section 1793.2.</u></p> <p><u>(C) Replacement. For purposes of this regulation, a manufacturer who, pursuant to subdivision (d)(2) of Civil Code section 1793.2, replaces a non-conforming motor vehicle with a new motor vehicle substantially identical to the motor vehicle replaced is replacing the motor vehicle under the terms of the mandatory warranty. No additional tax is due unless the buyer is required to pay an additional amount to receive the replacement motor vehicle, in which case tax is due measured</u></p>	



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	<p><b>(c) REPLACEMENT PARTS--WARRANTIES.</b></p> <p>(1) IN GENERAL--DEFINITIONS. "Mandatory Warranty." A warranty is mandatory within the meaning of this regulation when the buyer, as a condition of the sale, is required to purchase the warranty or guaranty contract from the seller. "Optional Warranty." A warranty is optional within the meaning of this regulation when the buyer is not required to purchase the warranty or guaranty contract from the seller, i.e, he is free to contract with anyone he chooses.</p> <p>(2) MANDATORY WARRANTIES. The sale of tangible personal property includes the furnishing, pursuant to the guaranty provisions of the contract of sale, or mandatory warranty, of replacement parts or materials, and if the property subject to the warranty is sold at retail, the measure of the tax includes any amount charged for the guaranty or warranty, whether or not separately stated. The sale of the replacement parts and materials to the seller</p>	<p><u>by the amount of that payment. If an amount is refunded to the customer as part of the exchange of the non-conforming motor vehicle for the replacement motor vehicle, then that amount is regarded as restitution for purposes of this regulation if it satisfies the requirements of subdivision (d)(2) of Civil Code section 1793.2. The manufacturer may file a claim for refund under subdivision (b)(2)(B) of this regulation for the amount of sales tax or sales tax reimbursement that is included in the amount of that restitution paid by the manufacturer to the buyer. For purposes of this regulation, the number of attempts made to repair the non-conforming motor vehicle, if any, prior to providing the customer a replacement is not relevant for purposes of determining whether the replacement has been made pursuant to subdivision (d)(2) of Civil Code section 1793.2.</u></p> <p><b>(c) REPLACEMENT PARTS--WARRANTIES.</b></p> <p>(1) IN GENERAL--DEFINITIONS. "Mandatory Warranty." A warranty is mandatory within the meaning of this regulation when the buyer, as a condition of the sale, is required to purchase the warranty or guaranty contract from the seller. "Optional Warranty." A warranty is optional within the meaning of this regulation when the buyer is not required to purchase the warranty or guaranty contract from the seller, i.e., <del>he</del> <u>the buyer</u> is free to contract with anyone <u>he or she</u> chooses.</p> <p>(2) MANDATORY WARRANTIES. The sale of tangible personal property includes the furnishing, pursuant to the guaranty provisions of the contract of sale, or mandatory warranty, of replacement parts or materials, and if the property subject to the warranty is sold at retail, the measure of the tax includes any amount charged for the guaranty or warranty, whether or not separately stated. The sale of the replacement parts and materials to the seller</p>	

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	<p>furnishing them thereunder is a sale for resale and not taxable.</p> <p>(3) OPTIONAL WARRANTIES. The person obligated under an optional warranty contract to furnish parts, materials, and labor necessary to maintain the property is the consumer of the materials and parts furnished and tax applies to the sale of such items to <del>him</del>. If he purchased the property for resale, without tax paid on the purchase price, he must report and pay tax upon the cost of such property to him when he appropriates it to the fulfillment of the contract of warranty.</p>	<p>furnishing them thereunder is a sale for resale and not taxable.</p> <p>(3) OPTIONAL WARRANTIES. The person obligated under an optional warranty contract to furnish parts, materials, and labor necessary to maintain the property is the consumer of the materials and parts furnished and tax applies to the sale of such items to <del>him</del><u>that person</u>. If he <u>or she</u> purchased the property for resale <u>or from outside California</u>, without tax paid on the purchase price, he <u>or she</u> must report and pay tax upon the cost of such property to him <u>or her</u> when he <u>or she</u> appropriates it to the fulfillment of the contract of warranty.</p> <p><u>(4) DEDUCTIBLES. A deductible paid by a customer under the terms of a mandatory or optional warranty contract is subject to tax measured by the amount of the deductible allocable to the sale of tangible personal property to the customer. For example, if the itemized sales price of tangible personal property (or the fair retail value if not separately itemized) provided pursuant to a warranty is 50 percent of the total fair retail value of the repairs and the deductible is \$100, 50 percent of that deductible, \$50, would be allocable to the sale of tangible personal property and would be subject to tax, whether the warranty were optional or mandatory. Unless otherwise stated in the warranty contract, when either an optional or a mandatory warranty provides that the customer will pay a deductible towards repairs and services provided under the warranty, the person providing the warranty contract is liable for any tax or tax reimbursement otherwise payable by the customer with respect to that deductible.</u></p>	

**Regulation 1655.****Returns, Defects and Replacements.**

*References:* Sections 6006-6012, Revenue and Taxation Code; Sections 1793.2-1793.25, Civil Code;  
Section 11713.12, Vehicle Code.  
Barter, Exchange, Trade-Ins, see Regulation 1654.  
Auction Sales, agreement not to deliver property or to return amount paid, see Regulation 1565.

**(a) RETURNED MERCHANDISE.** The amount upon which tax is computed does not include the amount charged for merchandise returned by customers if, (1) the full sale price, including that portion designated as "sales tax", is refunded either in cash or credit and (2) the customer, in order to obtain the refund or credit, is not required to purchase other property at a price greater than the amount charged for the property that is returned. Refund or credit of the entire amount is deemed to be given when the purchase price, less rehandling and restocking costs, is refunded or credited to the customer. The amount withheld for rehandling and restocking may not exceed the actual cost of rehandling and restocking the returned merchandise. However, in lieu of using the actual cost for each transaction, the amount withheld for rehandling and restocking may be a percentage of the sales price determined by the average cost of rehandling and restocking returned merchandise during the previous accounting cycle (generally one year). If the seller elects to withhold rehandling and restocking amounts based on a percentage of sales price, the seller is bound by that election for the entire accounting cycle for which the election is made and must apply that percentage in lieu of actual cost during that period on all returned merchandise transactions for which rehandling and restocking costs are withheld. The amount withheld as rehandling and restocking costs may not include compensation for increased overhead costs because of the return, for refinishing or restoring the property to salable condition where the necessity therefor is occasioned by customer usage, or for any expense prior to the "sale" (i.e., transfer of title, lease, or possession under a conditional sale contract).

Sellers must maintain adequate records which may be verified by audit, documenting the percentage used.

**(b) DEFECTIVE MERCHANDISE.**

(1) IN GENERAL. Amounts credited or refunded by sellers to consumers on account of defects in merchandise sold may be excluded from the amount on which tax is computed. If, however, defective merchandise is accepted as part payment for other merchandise and an additional allowance or credit is given on account of its defective condition, only the amount allowed or credited on account of defects may be excluded from taxable gross receipts. The amount allowed as the "trade-in" value must be included in the measure of tax.

(2) RESTITUTION OR REPLACEMENT UNDER CALIFORNIA LEMON LAW.

(A) General. Under subdivision (d) of Civil Code section 1793.2, if a manufacturer is unable to service or repair a "new motor vehicle," as that term is defined in subdivision (e)(2) of Civil

Code section 1793.22, to conform to the applicable express warranties after a reasonable number of attempts, the manufacturer must either replace the motor vehicle or provide the buyer restitution of the purchase price, less specified amounts, at the buyer's election.

(B) Restitution. A manufacturer who pays a buyer restitution pursuant to, and in complete compliance with, subdivision (d)(2) of Civil Code section 1793.2 is entitled to a refund of the amount of sales tax or sales tax reimbursement included in the restitution paid by the manufacturer to the buyer. The manufacturer may file a claim for refund of that amount with the board. The claim must include a statement that the claim is submitted in accordance with the provisions of section 1793.25 of the Civil Code. The manufacturer must submit with the claim documents evidencing that restitution was made pursuant to, and in complete compliance with, subdivision (d)(2) of Civil Code section 1793.2 including: a copy of the original sales agreement between the buyer and the dealer of the non-conforming motor vehicle; copies of documents showing all deductions made in calculating the amount of restitution paid to the buyer along with full explanations for those deductions, including settlement documents and odometer statements; a copy of the title branded "Lemon Law Buyback" for the non-conforming motor vehicle returned by the buyer; and proof that the decal the manufacturer is required to affix to that motor vehicle has been so affixed in accordance with section 11713.12 of the Vehicle Code. The manufacturer must also submit with the claim the seller's permit number of the dealer who made the retail sale of the non-conforming motor vehicle to the buyer, and evidence that the dealer had reported and paid sales tax on the gross receipts from that sale. For purposes of this regulation, the number of attempts made to repair the non-conforming motor vehicle, if any, prior to providing the customer restitution is not relevant for purposes of determining whether restitution has been made pursuant to subdivision (d)(2) of Civil Code section 1793.2.

(C) Replacement. For purposes of this regulation, a manufacturer who, pursuant to subdivision (d)(2) of Civil Code section 1793.2, replaces a non-conforming motor vehicle with a new motor vehicle substantially identical to the motor vehicle replaced is replacing the motor vehicle under the terms of the mandatory warranty. No additional tax is due unless the buyer is required to pay an additional amount to receive the replacement motor vehicle, in which case tax is due measured by the amount of that payment. If an amount is refunded to the customer as part of the exchange of the non-conforming motor vehicle for the replacement motor vehicle, then that amount is regarded as restitution for purposes of this regulation if it satisfies the requirements of subdivision (d)(2) of Civil Code section 1793.2. The manufacturer may file a claim for refund under subdivision (b)(2)(B) of this regulation for the amount of sales tax or sales tax reimbursement that is included in the amount of that restitution paid by the manufacturer to the buyer. For purposes of this regulation, the number of attempts made to repair the non-conforming motor vehicle, if any, prior to providing the customer a replacement is not relevant for purposes of determining whether the replacement has been made pursuant to subdivision (d)(2) of Civil Code section 1793.2.

### **(c) REPLACEMENT PARTS--WARRANTIES.**

(1) IN GENERAL--DEFINITIONS. "Mandatory Warranty." A warranty is mandatory within the meaning of this regulation when the buyer, as a condition of the sale, is required to purchase the warranty or guaranty contract from the seller. "Optional Warranty." A warranty

is optional within the meaning of this regulation when the buyer is not required to purchase the warranty or guaranty contract from the seller, i.e., ~~he~~the buyer is free to contract with anyone he or she chooses.

(2) MANDATORY WARRANTIES. The sale of tangible personal property includes the furnishing, pursuant to the guaranty provisions of the contract of sale, or mandatory warranty, of replacement parts or materials, and if the property subject to the warranty is sold at retail, the measure of the tax includes any amount charged for the guaranty or warranty, whether or not separately stated. The sale of the replacement parts and materials to the seller furnishing them thereunder is a sale for resale and not taxable.

(3) OPTIONAL WARRANTIES. The person obligated under an optional warranty contract to furnish parts, materials, and labor necessary to maintain the property is the consumer of the materials and parts furnished and tax applies to the sale of such items to ~~him~~that person. If he or she purchased the property for resale or from outside California, without tax paid on the purchase price, he or she must report and pay tax upon the cost of such property to him or her when he or she appropriates it to the fulfillment of the contract of warranty.

(4) DEDUCTIBLES. A deductible paid by a customer under the terms of a mandatory or optional warranty contract is subject to tax measured by the amount of the deductible allocable to the sale of tangible personal property to the customer. For example, if the itemized sales price of tangible personal property (or the fair retail value if not separately itemized) provided pursuant to a warranty is 50 percent of the total fair retail value of the repairs and the deductible is \$100, 50 percent of that deductible, \$50, would be allocable to the sale of tangible personal property and would be subject to tax, whether the warranty were optional or mandatory. Unless otherwise stated in the warranty contract, when either an optional or a mandatory warranty provides that the customer will pay a deductible towards repairs and services provided under the warranty, the person providing the warranty contract is liable for any tax or tax reimbursement otherwise payable by the customer with respect to that deductible.